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Lenin was right…

« By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens. By this method they not only confiscate, but they confiscate arbitrarily; and, while the process impoverishes many, it actually enriches some. » - *« Lenin was certainly right. There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million can diagnose. »*

Excerpt from "The Economic Consequences of the Peace" – *John Maynard Keynes*

It may seem paradoxical to mention a quotation related to inflation in a context where the price of oil has collapsed by 50% in six months and where every set of statistics confirms the absence of bullish pressure on the general level of consumer prices. However inflation is a multi-faceted object. It can take on many different forms and faces which are not necessarily visible to the majority of the population. It sometimes takes the form of a real-estate bubble, an increase in the price of food or of commodities or else in the salaries of certain sectors of the population (employees, civil servants…). It is sometimes visible in the traditional economic indicators (consumer price indexes) but may also remain hidden in the sphere of financial markets. Nevertheless, in all cases, inflation is always favourable to some and detrimental to others. This is what Keynes and Lenin were asserting.

By lowering the level of interest rates to zero, the central banks of most developed countries have put in place a special form of inflation known as « financial repression ». Financial repression consists of no longer remunerating savers and on the contrary favouring those in debt to ensure that they do not go bankrupt. This is what Keynes elegantly called « the euthanasia of the rentier ».

Financial repression is a policy adopted by central banks when the indebtedness of the government has become too great. This is the case of those developed countries which, since the bursting of the American real estate bubble in 2008 took over a large number of private debts in order to prevent the bankruptcy of certain players. To give an idea of the scale of this phenomenon, the American public debt rose from 64% of GDP in 2007 to 104% today. Over the same period the French public debt rose from 64% of GDP to 95% and that of the United Kingdom from 43% to 85% of GDP (IMF data). In order to lighten the burden of the interest on Treasury debts, the central banks of the USA, the UK, Japan and from now on also the Eurozone countries have lowered the level of nominal interest rates to 0% and the level of real interest rates into negative territory (real interest rate = nominal interest rate – inflation).

Thus, after having progressively lowered interest rates to zero, the European Central Bank has finally crossed the Rubicon by launching its programme of Quantative Easing. The European QE should automatically lead to an increase in the mass of money in circulation by more than 1'000 billion Euros over the next 18 months, i.e. 7% of the GDP of the zone.

The stated objective of the ECB is to attain an inflation « below 2% but close to that level », even at the price of financial repression, that is to say even if it is favourable to some and detrimental to others. Among the main beneficiaries, let us name those most directly concerned:

1- Governments, which find here a source of financing which is almost nil ;
2- Banks and insurance companies, the main holders of bonds, which under the regulations have a strong incentive to give priority to lending to the Government ;
3- High-net-worth individuals and major shareholders, who also hold financial assets.

The further one moves away from these three groups, the less impact the stimulus will have. Retirees and small investors are among those who are likely to get the least benefit in their financial situation.

Inflation is hidden in the valuation of financial assets:

Government bonds are often treated like a risk free asset. Their prices act as a point of reference when making rational investment decisions. In fact, any investment in any other asset (whether stocks, corporate bonds, rental property, etc.) will only be made after having compared the potential reward it offers over the reward offered by an investment without risk. This is what is called the risk premium.

For example, if the risk-free rate is 5%, then assets with risk must offer a potential reward of more than 5% if they are to be economically justified. On the contrary, if the risk-free rate is close to zero, any asset offering any positive reward becomes attractive and will therefore be bought by investors.

Consequently, by buying Treasury bonds (a risk-free asset « par excellence ») the ECB does not only change the price of Treasury bonds themselves, but also influences (upwards) the whole range of prices of financial assets – especially corporate shares and corporate bonds.

In a period of financial repression, inflation is not necessarily felt in prices in the real economy but is concentrated on the prices of financial assets. This works in favour of holders of these financial assets themselves (banks, governments, shareholders in quoted companies) and is unfavourable for those who do not have any such assets and creates a wealth gap between those who benefit from this policy and those who do not.

This divergence of wealth is likely to revive tensions and to divide a society: the poor are resentful towards the rich, the rich blame their government, the Greeks are hostile to Germany, private businessmen are resentful towards the bankers and few are those who are capable of putting a finger on the object their woes.

The invisible increase in the level of risk

As is often the case, the rise in the markets brings about a distorted perception of reality. Risks have not really disappeared, but the fact that there is a buyer of last resort in case of problems (the central banks) leads sometimes to imprudent behaviour.

Thus, gradually as prices of stocks and bonds progress, dependence on Quantative Easing increases until the prices of financial assets lose their connection with the growth in the real economy (household consumption, investment and business results). Any change in monetary policy then becomes a painful choice, which may lead to a brutal drop in market prices. This is the stage that the American central bank has reached having stopped its programme of asset purchases but still does not seem to be in any hurry to move on to a first increase in interest rates.

We will make the most of the markets rise but remain very vigilant. While the zero-rate policy allows an expansion in the valuation of assets, it also has another consequence: it makes certain investments profitable which would not have been so under normal interest-rate conditions (rates close to the nominal growth in GDP) and it encourages us to keep alive certain projects which otherwise would have been destined for bankruptcy. The extremely accommodating monetary policy of the central banks gives relief to the borrowers but brings an accumulation of the credits financing projects which have limited profit potential and are extremely sensitive to any unexpected factor (increase in interest rates or decline in the price of the asset being financed).

The most recent illustration of this phenomenon concerns the American petroleum industry. The collapse of the value of a barrel of oil (dropping from $100 a barrel to less than $50 today) has brought about the closing of many projects linked to the exploitation of shale oil and the bankruptcy of companies in this sector. The companies which were only viable on condition that crude oil remained above $70 per barrel and financed by debt have shut down. Fortunately, they were for the most part financed by the issuance of bonds on the financial markets and not by bank loans. Losses have therefore been borne only by the unfortunate bearers of these bonds. By deciding to allow these bankruptcies to occur, that is to say by sacrificing the lenders, there has not been any impact on the banking system and other sectors of the economy.

Investment strategy

This first quarter of 2015 has seen several key events. Between the introduction of Quantitative Easing by the European Central Bank, the decline in commodities' prices and the remarkable strengthening of the US dollar (+10% against the Euro since the start of the year) markets have found a series of reasons justifying a continued rise in risky assets.

The present environment is characterised by high valuations in the stock and bond markets. We are aware of this. As long as this policy of financial repression is maintained, investment in stocks and corporate bonds in spite of their high price levels should continue to produce positive results in portfolios. We are in an up-trending market.

As detailed above, following the example of the American, Japanese and English central banks, Europe is now embarking on the path of financial repression, which is only a disguised form of inflation whose impact is essentially on the price of financial assets. The asset allocation of portfolios therefore logically focuses on assets favoured by monetary policies. European stocks, European corporate bonds and the government bonds of countries on the perimeter of the Eurozone are among the classes of assets which we favour. American assets, on the other hand, seem to fall into a different dynamic. Indeed the American central bank should launch in 2015 a first increase in the key interest rates. Although the American economy seems to be in full upswing (declining unemployment, increasing consumption and corporate profits still moving upwards) one of the major factors for support of the rise in asset prices is about to disappear, namely the expansionist monetary policy.

We are all well aware that the prices of stock and bond markets are no longer cheap. Therefore we are particularly alert to any signs of change in the overall trend.

One of the negative impacts of financial repression is the concentration of risk in security exchange valuations. Assets become correlated and make diversification unworkable. Short-term deposits, even with no return, thus become one of the most efficient options in a diversified portfolio. This is the tool which we shall use as long as this environment persists.

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